# The euro and the global crises: Finding the balance between short-term stabilisation and forward-looking reforms

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| [Joshua Aizenman](http://www.voxeu.org/index.php?q=node/1097) 5 June 2012 | [**Print**](http://www.voxeu.org/index.php?q=node/8064) [**Email**](http://www.voxeu.org/index.php?q=forward&path=node/8064) [**Comment**](http://www.voxeu.org/index.php?q=node/8064#comments) [**Republish**](http://www.voxeu.org/index.php?q=node/87) |

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| *The Eurozone crisis poses the single greatest downside risk to the global economic outlook. Were the founders of the euro hopelessly optimistic? This column argues that such crises present an opportunity for institutions to be put in place that prevent short-sightedness and increase the stability of the monetary union.*  It is a few years since the US-originated global crisis and the world economy now finds itself grappling with another crisis emanating from the OECD countries. The Eurozone sovereign debt crisis currently poses the single biggest downside risk to the global outlook. The crisis is rooted in the uneven growth performance of the different Eurozone countries, the unsustainably large public debts of some periphery countries, and the European banks’ exposure to these debts. These developments exposed the possible dynamic inconsistency of the euro project, dubbed by Pisani-Ferry (2012) as the ‘Euro Impossible Trinity’.[1](http://www.voxeu.org/index.php?q=node/8064#fn)  The short history of the euro project has been remarkable and unprecedented. Earlier concerns about the stability of the transition from national currencies to the euro, and scepticism regarding the gains from forming the euro, were deemed overblown during the 2000s. However, the real test of a currency union happens at times of sizable asymmetric shocks, like recessions impacting some states in the union, while other states boom. The slowing down of the periphery at a time when Germany kept growing awakened the market in 2010 to the growing debt overhang of the Eurozone’s periphery, and the incompleteness of the euro project. The resultant Eurozone crisis is testing the viability of the single currency.  Understanding the process that led to the vulnerabilities exposed by the global and the Eurozone crises is a pre-condition for grasping the necessary short-term stabilisation and reform. The generic answer to the timing of short-term stabilisation and forward-looking reform challenges is simple – it is best to enact the reforms in a forward-looking manner, during good times, reducing the cost of short-term stabilisations. In practice, unlike the generic answer, reforms are rarely enacted in a forward-looking manner during good times. In recent research ([Aizenman 2012](http://economics.ucsc.edu/research/downloads/The%20Euro%20crisis%20nber.pdf)), I analyse the evolutionary aspects of economic changes – illustrated in the context of the formation of the euro and the global financial crises. Evolutionary aspects of currency unions: The formation of the euro is an example of a common Panglossian attitude to policies and the formation of new institutions – an upbeat optimism that may help overcome the opposition. The hope is that the formation of a currency union (like the euro) may lead to dynamic forces inducing ‘ever closer union’, as the processes of market integration and cooperation do mutually reinforce each other. This approach also reflects an optimistic assessment of the ‘Endogenous Optimal Currency Area Theory’ (Frankel and Rose 1997).  Frequently, a Panglossian attitude to policies may reflect built-in fiscal myopia, possibly at the level of both the principal (the policymaker) and the agents (consumers and households). Individual fiscal myopia may reflect hyperbolic discounting, where the present-biased consumer excessively discounts future consumption relative to the conventional expected utility (Leibson 1997). Belt tightening is delayed for tomorrow, but ‘tomorrow never comes’. Policymakers’ fiscal myopia may reflect the ‘short-termism’ associated with a limited time in office, and the possible short-sightedness of hyperbolic discounting voters.[2](http://www.voxeu.org/index.php?q=node/8064#fn) Both patterns are associated with probable time inconsistency. In these circumstances, proper institutions may help. Yet, effective institutions can’t be imposed from the outside. Forming the institutions dealing with fiscal myopia frequently requires painful learning from crises, which in turn may galvanise the will to reform.  These considerations suggest an alternative perspective to the formation of institutions and policies – The Evolutionary Approach, where the formation of a new currency area is not unidirectional.[3](http://www.voxeu.org/index.php?q=node/8064#fn) Evolutionary pressure purges arrangements and institutions that do not survive the realised shocks. Yet, survival does not necessarily imply the ability to withstand future turbulences. Thus, convergence to ‘ever closer union’ is not assured. Taking this perspective, the ‘optimal currency area’ literature has been too simplistic. Unions and regional cooperation arrangements are challenged by exogenous forces, testing the willingness and ability to persevere during bad times. Market integration and cooperation may overshoot the willingness to integrate. Frequently, the reasons for the formation of currency unions and regional cooperation blend economics and politics. The euro has been the outcome of Europe’s 19th and 20th century history, rather than the ‘optimal currency areas’ logic.[4](http://www.voxeu.org/index.php?q=node/8064#fn)  Putting the Eurozone crisis in the proper historical context, the dollar is a ‘successful’ union of 50 states. Yet, this is the outcome of painful learning and a turbulent history of more than 200 years. Key chapters in this history include defaults of eight US states on sovereign debt in the early 1840s; the Civil War; the emergence of the Fed as a key institution, and the greater fiscal role of the federal system following the Second World War. The Eurozone is a ‘baby union’, facing its first painful maturing crisis. Eurozone countries attempted to ignore the learning process of the US and other unions, at their own peril. The crisis forces the emerging euro to move fast on the learning curve. The process is quite painful, as has been the learning process of the US.  There are alternative views of the fiscal factors contributing to the stability of unions.   1. Adding built-in fiscal restraints. Wallis (2005) attributes the success of the US dollar union to the institutional changes following the sovereign debt default of eight US states, leading to fiscal prudence: "After the fiscal crisis of the early 1840s, states changed their constitutions to eliminate taxless finance in the future.” 2. Are built-in fiscal restraints enough? Not necessarily. Von Hagen (1991) is sceptical about the effectiveness of fiscal restraints on states in the US: “Fiscal restraints significantly affect the probability of fiscal choices and performance, without however preventing extreme outcomes.” 3. Fiscal restraints supported by the proper allocation of bargaining clout. An alternative perspective may combine the above two views on the stability of a union. When the fiscal centre receives sizable taxes from the states, and provides significant discretionary transfers to the states, the union’s centre has plenty of bargaining clout. If a state misbehaves, the centre may cut the transfers to a degree that would prevent such behaviour. The centre’s bargaining clout strengthens the fiscal restraints on states’ over-borrowing. If this mechanism is powerful, the threat is enough to impose the necessary discipline. The states would refrain from running a large public debt-to-GDP ratio, and the threat of cutting transfers would be rarely used. In the US, this mechanism seems to be potent, as state governments receive a hefty share of their general revenue directly from the federal government – about 32% in 2009. Yet, if the credibility of the threat is questionable, it would be tested and used, as has been the case in Brazil (see Melo et al. 2010).  Implications for “stabilisation versus reform” Granting more bargaining clout to the centre will help the euro project to move forward. There are numerous ways of doing so, and it is up to the members to choose a way fitting their vision.  Improving fiscal discipline will help. Don’t eat more than you can chew and digest; borrow only if your tax base is big enough to support serving it. The fiscal distortions of the euro project go back to the Maastricht Treaty criteria of fiscal prudency, where a public debt-to-GDP ratio below 60% and fiscal deficit-to-GDP ratio below 3% were determined as key indicators of fiscal fitness. Yet in previous research (Aizenman et al. 2011), my co-authors and I point out that more robust and informative criteria for fiscal exposure are low public debt to average tax revenue and low fiscal deficit to average tax revenue.[5](http://www.voxeu.org/index.php?q=node/8064#fn)  In practice, the average tax revenue provides a good statistics on the de facto taxing capacity, being the outcome of the tax code and its effective enforcement. While the public debt-to-GDP ratio may increase rapidly in times of trouble (see Ireland in the recent crisis, more than doubling its public debt-to-GDP in one year), the de facto taxing capacity changes slowly in times of trouble, as parties tend to be locked in a war of attrition, attempting to minimise their adjustment burden. For a given similar unanticipated adverse fiscal shock, a country with lower public debt to average tax revenue would have more room to adjust by reallocating its priorities of using the relatively high tax base.[6](http://www.voxeu.org/index.php?q=node/8064#fn) Conclusion Crises are a way of testing the capabilities both to stabilise and to adopt forward-looking reforms that will prevent similar crises in future. Most of the necessary reforms take place under the gun of history, during the crisis or while the crisis is still fresh in the memory.  Authors note: The author would like to thank Michael Bordo, Brian Pinto, Albrecht Ritschl, Federico Sturzenegger, and the participants at the European Monetary Union: Lessons from the Debt Crisis OeNB\_40th Conference, May 2012, Vienna, for their comments. Any views presented are those of the author and not necessarily those of the NBER or the Austrian National bank. References Aizenman J (1998), “Fiscal Discipline in an Union”, in F Sturzenegger and M Tommasi (eds.), The Political Economy of Economic Reforms, A preliminary version: NBER Working Paper # 4656.  Aizenman, J (2012), “The Euro and the global crises: finding the balance between short term stabilization and forward looking reforms”, NBER Working Paper.  Aizenman, J, M Hutchison and Y Jinjarak (2011), “What is the Risk of European Sovereign Debt Defaults? Fiscal Space, CDS Spreads and Market Pricing of Risk”, NBER Working Paper No. 17407.  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Wallis J (2005), “Constitutions, Corporations, and Corruption: American States, 1842 to 1852”, Journal of Economic History, 211-256.  von Hagen J (1991), “A note on the empirical effectiveness of formal fiscal restraints”, Journal of Public Economics, 44(2):199-210.  1 The three attributes of the euro project hindering the adjustment capabilities of the Eurozone countries are: the strict no-monetary financing; the bank-sovereign interdependence, and the no co-responsibility for public debt in the Eurozone. Pisani-Ferry (2012) pointed out that at least one of these attributes should be modified to enhance the stability of the euro project.  2 See Aizenman (1998) for a model of the moral hazard associated with policy makers’ short-termism and states’ overspending in a union. 3 Evolutionary logic in Economics goes back to Veblen (1899) and the Austrian evolutionary school.  4 The collapse of Yugoslavia, and the move towards more limited fiscal federalism in Canada provides vivid examples of these patterns. See Bordo and Jonung (1999) for detailed overviews of the history of unions. 5 Ideally, the ratio of public debt to the net present value of future primary surpluses is a good measure of fiscal burden. Yet, properly estimating this net present value is elusive. 6 This logic suggests that public debt to average tax collection and fiscal deficits to average tax collections account better for the sovereign risk than indicators deflating public debt and fiscal deficits by the GDP. Indeed, our research (Aizenman et al. 2011) confirms this observation. |

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